United Nations A/69/188

General Assembly

Distr.: General
25 July 2014

Original: English

Sixty-ninth session
Item 17 (b) of the provisional agenda*
Macroeconomic policy questions

International financial system and development

Report of the Secretary-General**

Summary

The present report, submitted pursuant to General Assembly resolution 68/201, contains information on recent trends in international official and private capital flows to developing countries and current efforts to strengthen the international financial system towards the post-2015 development agenda. Ongoing challenges in the key areas of financial regulation, sovereign debt distress, the global financial safety net, multilateral surveillance, policy coordination and governance reform of the international financial institutions are highlighted.

* A/69/150.

** The present report was prepared in consultation with staff from the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations Secretariat.

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I. Introduction

1. In its resolution 68/201 on the international financial system and development, the General Assembly recognized the need to continue and intensify efforts to enhance the coherence and consistency of the international financial system, and to act decisively to tackle the challenges confronting the global economy, in order to ensure balanced, sustained, inclusive and equitable global growth. It also reiterated the need for significant mobilization of resources from a variety of sources and the effective use of financing in order to promote full and productive employment and decent work for all. As recognized in the Monterrey Consensus, an enabling international environment, including a stable international financial system, is required for the achievement of development goals.

2. There has been progress in regulatory reforms launched in the wake of the financial crisis, which have significantly reduced some important risks in the financial system. Nonetheless, a number of structural flaws, regulatory gaps, barriers and misaligned incentives continue to pose risks to financial stability. Many private financial flows remain short-term oriented and subject to bouts of extreme volatility. Official development assistance and other forms of official flows risk being affected by greater fiscal austerity and sovereign debt problems in developed countries, while the risk of debt distress remains in some developing countries.

3. An effective and stable financial system is necessary for the allocation of resources for global goals and sustainable development needs. Discussions on the post-2015 development agenda have highlighted the enormous needs for financing the social, economic, and environmental dimensions of sustainable development. Long-term financing will be essential for raising the resources required for achieving the post-2015 development agenda. Yet, to date, the international financial system has failed to adequately allocate resources for long-term sustainable development needs. There has been insufficient investment in critical areas, such as infrastructure, small and medium-sized enterprises and financial services for all, the technologies necessary to address climate change in both developed and developing countries, and health, education and sanitation services for the world's poor.

4. To achieve the post-2015 development agenda, the financial system needs to intermediate credit towards sustainable development in a stable manner. Ultimately, stability and sustainability are mutually reinforcing, as without a stable financial system, the post-2015 development agenda risks being derailed by future regional or global financial crises.

II. Reserve accumulation and global imbalances

5. Global imbalances on the current accounts of major countries narrowed slightly in 2013. They are projected to decrease modestly, helped by lower surpluses among energy exporters, and are not expected to widen by a significant margin in the coming two years.[1] The stabilization in global imbalances in part reflects a cyclical downturn and weak external demand in deficit countries. In addition, it reflects some structural improvements in the domestic structure of some economies.

[1] *World Economic Situation and Prospects 2014* (United Nations publication, Sales No. E.14.II.C.2).

For example, the narrowing in the external surplus of China reflects in part a more flexible exchange rate. Nonetheless, much of the structural issues underlying global imbalances remain, which continue to pose a risk to long-term economic stability.

6. The pace of reserve accumulation in emerging markets and developing economies slowed in 2013, reflecting widening current account deficits in a number of developing countries, along with lower capital inflows. Nonetheless, central banks continue to hold a large proportion of global savings in the form of international reserves. From 2000 to 2013, foreign exchange reserves increased from $2.1 trillion to $11.7 trillion, with emerging and developing countries holding an estimated $7.9 trillion and accounting for about 68 per cent of the total.[2] In 2014, annual reserve accumulation is expected to be around $550 billion.[3]

7. For many countries, reserves are a form of "self-insurance" against potential external shocks. Consequently, according to IMF, these countries typically invest reserves in safe liquid assets, with United States treasury securities accounting for 61 per cent of global foreign exchange reserves. The continued accumulation of safe low-yielding investments comes at significant opportunity costs, since reserves could have been invested in domestic resources at much higher returns and with a greater developmental impact.

8. Reserve accumulation can also be the by-product of central bank interventions in foreign exchange markets aimed at smoothing exchange rate volatility associated with excessive capital inflows and outflows. As such, reserve accumulation has been highly correlated with global liquidity and changes in international investor sentiment. At the same time, reserves can be a by-product of export-led growth strategies that maintain an undervalued currency through interventions in the currency market.

9. However, precautionary reserve accumulation, while sensible at the national level, increases systemic risk at the international level, by adding to global imbalances. Several proposals have been put forward to reduce global imbalances, including making greater use of International Monetary Fund (IMF) special drawing rights as a low-cost alternative to accumulation of international reserves. In addition, reducing risks in the international financial system would allow countries to reduce self-insurance and reallocate reserves towards sustainable and productive investment. As discussed in sections of the present report, measures to reduce risks include addressing capital market volatility, strengthening international regulation and reducing the risks of banking crises, increasing the predictability of official development assistance, reducing systemic implications of sovereign debt crises, and strengthening global governance.

III. International private financial flows to developing countries

10. Private investment will be vital to achieving sustainable development objectives. However, while there is a clear correlation between investment and growth, it remains important to distinguish between short-term and long-term

[2] International Monetary Fund (IMF), Currency Composition of Official Foreign Exchange Reserves database (31 March 2014).

[3] IMF, *World Economic Outlook: Recovery Strengthens, Remains Uneven* (Washington, D.C., 2014).

investments. Foreign direct investment (FDI) has the potential to advance economic development in a number of ways, including by increasing the productive capacity in recipient countries. Short-term oriented flows, by contrast, may carry more risks for economic stability and can lead to exchange rate overshooting or sudden price reversals. Furthermore, not all FDI has the same developmental impact; certain types of FDI, such as greenfield investment, have a greater impact on jobs and development.

A. Foreign direct investment

11. FDI to developing countries has followed a strong upward trend over the past decade. Since 2002, FDI flows to developing economies have more than quadrupled, reaching $759 billion, or 52 per cent of global FDI, in 2013. Nevertheless, FDI to developing countries has been limited to few countries and sectors, particularly in Asia and Latin America. Although flows to Africa increased in the past decade, they remain limited and directed mainly to the extractive sectors, which have less of an impact on employment than investment in other sectors (see E/2014/53).

12. Greenfield FDI to developing countries, which is the form of FDI that has the most impact on domestic growth, has fallen by more than 50 per cent since the crisis, signalling a potential reduction of the impact of FDI on the real economy or sustainable development. Although the value of announced greenfield projects to least developed countries increased by 9 per cent in 2013, it remains significantly below historical levels.[4] The composition of FDI in terms of flows to developing countries (between equity, reinvested capital and other capital representing intracompany loans) has been relatively stable for almost a decade at the global level. However, databases that do not consider intracompany transfers show a much lower increase in FDI — only about 7 per cent for emerging economies, versus 18 per cent for net FDI inflows overall. This implies that much of the increase in FDI has been in intracompany loans, which are often short-term and not investment oriented.[1] Outward FDI from developing countries, particularly by Brazil, the Russian Federation, India, China and South Africa, has also increased sharply, reaching $553 billion, or 39 per cent of total outward FDI, in 2013.[4]

B. Portfolio flows and institutional investors

13. The nature of portfolio investment in emerging markets has evolved over the past 15 years, as many country markets have deepened and become more globally integrated. In particular, as domestic debt markets have grown, foreign investors have increased their purchases of local currency debt and now play a dominant role in some emerging markets. The share of emerging market bonds and equities in global investors' portfolios has risen sharply over the past decade, supported by their growing importance in the world economy, the decline in their relative credit risk compared with advanced economies and improvements in credit ratings, and low yields in advanced economies. Overall, there is evidence that financial deepening for emerging markets and developing countries reduces price sensitivity of domestic markets to external shocks, but that the participation of foreign

[4] *World Investment Report 2014* (United Nations publication, Sales No. E.14.II.D.1).

investors can potentially increase foreign contagion and instability.[5] In addition to sound macroeconomic policies, improved governance and institutions have an important impact on a country's vulnerability to crises.

14. In 2013, net portfolio capital flows to developing countries turned negative, as longer-term interest rates in the United States of America rose. Inflows declined by 50 per cent, while outflows increased only moderately. In particular, the sell-off in financial assets was in large part due to expectations of an end of quantitative easing in the United States. This was exacerbated by economic weakness in some large emerging economies, including Brazil, India, Indonesia, the Russian Federation, Turkey and South Africa. Countries with large current account deficits who recently received large inflows have been most vulnerable to these developments.[1] In particular, there was a decline in portfolio equity inflows to India, the Republic of Korea, and credit flows to Indonesia. Currencies depreciated sharply and equity markets fell, owing to portfolio outflows in Brazil, India, Indonesia, Mexico, South Africa and Turkey.

15. Initial data from 2014 suggest that capital inflows in 2014 will be lower than in 2013, although they are expected to pick up slowly thereafter, in line with the expected recovery in global growth.[3] Nonetheless, significant uncertainties and downside risks remain from the interaction between perceptions of the United States Federal Reserve's tightening path and the idiosyncratic weaknesses in some emerging markets.[6]

16. The pattern of expansion and retrenchment in portfolio flows in the past years highlights the volatility in international capital flows and the spillover effects of advanced economy policies vis-à-vis developing countries. Macroprudential measures, capital account management techniques, and foreign exchange interventions can help to reduce the volatility of capital flows, and should thus be seen as an essential part of the policy toolkit to combat capital flow surges and outflows. The development of domestic long-term investor bases, such as local pension markets, along with incentives to encourage long-term investment horizons is important for ensuring that financial deepening acts in the interest of development and promotes long-term investment. Strengthening the institutional framework is important in this regard.

17. On a global level, policies can help to create incentives for pension funds, insurance companies, sovereign wealth funds and other investors with long-term liabilities to invest in sustainable development. In particular, institutional investors, who are estimated to hold between $75 and $85 trillion in assets, have been recognized as a potential significant source of long-term financing for sustainable development. Investors with long-term liabilities, such as pension funds, life insurance companies, and sovereign wealth funds, which are particularly well suited to invest with longer time horizons, are estimated to hold around $60 trillion. Yet, they continue to invest in liquid assets, often with a short-term investment horizon and, to date, account for at least some of the volatility referred to above. Despite their long-term liabilities, investment in infrastructure globally represents less than 3 per cent of pension fund assets, with lower allocations for infrastructure in developing countries and low-carbon infrastructure.[1]

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[5] IMF, *Global Financial Stability Report 2014* (April 2014).

[6] IMF, *World Economic Situation and Prospects 2014: Update as at mid-2014*.

18. One impediment to long-term direct investment by institutional investors is that many investors do not have the capacity to do the necessary due diligence to invest directly in infrastructure and other long-term assets, with the investment in capacity not justified, given the cost structure. Instead, they make these investments through secondary financial intermediaries, whose incentives tend to be much more short-term.[7] An alternative would be for investor groups to build joint platforms, for example, for clean infrastructure investments. This is already beginning to happen, albeit only on a small scale. ATP, the Danish pension fund, has announced that it will set up a climate change fund as a new entity for investing in emerging economies, and has invited other European investors to participate. Other policies to provide incentives for greater long-term investment include regulatory reforms, a re-examination of the implications of mark-to-market accounting on institutional investors' investments and trading activity, and changes to the structure of staff evaluation/compensation schemes.[1]

19. Given the cross-border spillover effect of monetary policy decisions, better international coordination of monetary policies and better management of global liquidity are needed to reduce global risks. Consideration also needs to be given to creating incentives for longer-term investments by banks and non-bank financial institutions, something which necessitates reforms in international financial regulation.

IV. Strengthening international financial regulation

20. In recent years, the international community has taken important steps to strengthen the resilience of the financial sector through regulatory reform and reduce the risk of future crises. To date, these reforms have focused on ensuring safety and soundness of the financial system, primarily through regulation of the banking sector through Basel III, supplemented by a series of recommendations from the Financial Stability Board.

21. The ultimate goal of the financial system is to facilitate the flow of funds from savers to borrowers and to effectively allocate funds throughout the economy. Safety and soundness (of both individual institutions and the financial system more broadly) is crucial for this effort. However, the financial system also needs to address the broader goal of access to credit if it is to effectively contribute to sustainable development.

22. Reducing risks while promoting access to credit presents a complex challenge for policymakers, since there can be trade-offs between the two. For example, in the extreme, a safer financial system would only lend to AAA or other highly rated borrowers, such as developed country sovereign bonds — but this clearly would not be an effective allocation of resources for long-term growth. The regulatory and policy framework thus needs to strike a balance between stability — particularly in reducing systemic risks — and access. Despite important progress in reforms, for the financial system to be able to contribute to the post-2015 development agenda and work in the interest of long-term sustainable global development, more needs to be done.

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[7] While larger managers manage more liquid portfolios in house, almost all use external managers for less liquid investments.

23. The current approach to the reform of international financial regulation has focused primarily on ensuring the safety and soundness of the financial system, centred on the banking sector through Basel III. Much progress has been made on this front and most large internationally active banks are on course to meet the new Basel III capital requirements in advance of the agreed deadline.[8] Basel III reforms include higher minimum capital requirements, an improved quality of capital, a leverage ratio and larger liquidity buffers (inclusive of off-balance sheet obligations).[9] Along with the traditional microprudential approaches, which focus on reducing risks of individual banks, Basel III also attempts to strengthen the macroprudential policy framework, through the introduction of a counter-cyclical capital buffer, though it is unclear whether this will be strong enough to achieve its intended purpose.

24. There is a concern that, by generally raising the cost of lending, the Basel capital adequacy rules may have the effect of limiting riskier lending. Indeed, the rules are designed to impose higher costs on risky activities of banks to internalize the costs of risky behaviour. Yet, some higher risk sectors are precisely those that need investment for achieving sustainable development. For example, longer-term lending, entities with low credit ratings, as well as areas where it is more costly to get information, such as those without sufficient data on default histories or without credit ratings, are naturally subjected to higher capital and provisioning costs. As a result, there has been particular concern regarding the impact of these regulations on long-term lending, including infrastructure lending, trade finance, innovation and green technologies, small and medium-sized enterprise financing, as well as lending to developing countries. In response to these risks, some countries have made some adjustments. For example, concerned with the risk of reduced small and medium-sized enterprise lending, the European Union excluded such exposures from the calculation of capital conservation buffer requirements.[10]

25. There are also concerns that tighter bank regulations, in conjunction with the complexity of the Basel capital and liquidity adequacy measurement framework, may trigger a new wave of regulatory arbitrage. More generally, complex regulations can be difficult to implement and costly to supervise. This argues for broad-based, simpler regulations that incorporate both balance sheet and off-balance sheet exposures, such as the leverage ratio introduced by Basel III, which has some counter-cyclical effects built in. Nonetheless, there would still be a risk that lending requiring higher capital would shift from regulated banking activities to shadow banking.

26. In recent years, the term "shadow banking" has been used more broadly as a synonym for "non-bank credit intermediation".[11] The term was originally introduced to refer to activities of financial intermediaries who are involved in

[8] Basel Committee on Banking Supervision, *Progress Report on Implementation of the Basel Regulatory Framework* (April 2014).

[9] Basel III introduced two required liquidity ratios. The "Liquidity Coverage Ratio" was supposed to require a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days; the "Net Stable Funding Ratio" was to require the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

[10] Basel II, para. 231 (definition of retail exposures), and article 501 of the Capital Requirements Regulations.

[11] Financial Stability Board, *Global Shadow Banking Monitoring Report 2013*.

facilitating the creation of credit, and whose members are not subject to regulatory oversight. In that context, the shadow banking system also refers to unregulated activities by regulated institutions, including banks.

27. The value of shadow banking assets is difficult to estimate. However, based on data on the size of non-bank financial intermediaries, it grew by $5 trillion to $71 trillion in 2012. While, by absolute size, advanced economies remain the ones with the largest non-bank financial systems, emerging markets showed the most rapid increases in non-bank financial system assets, outside of the regulatory framework.[11] To the extent that this increase represents the development of capital markets and areas of inclusive finance, this could indicate a positive development. However, the growth of non-bank financial activities needs to be monitored carefully and incorporated into the broader regulatory system to avoid significant increases in risks related to excessive financial leverage, and to ensure consumer protection. In this regard, coordination among a wide array of public and private actors is vital in order to arrive at a regulatory framework that promotes financial inclusiveness, along with stability.

28. The Financial Stability Board is working to further strengthen the oversight and regulation of the shadow banking sector. In that context, it has agreed on an information-sharing process to support implementation of the policy framework for oversight and regulation of shadow banking entities other than money market funds. The Board will launch a peer review on national implementation of the high-level policy framework in 2015.[12]

29. The Financial Stability Board also developed the policy framework to address financial stability risks associated with securities financing transactions. In addition, the Basel Committee on Banking Supervision has finalized its supervisory framework for large exposures and risk-sensitive capital requirements for banks' investments in equity of funds, which should help to mitigate spillover effects between banks and shadow banking entities.

30. Another area that has received global attention is that of "too-big-to-fail" institutions. During the global financial crisis, large financial institutions, in particular, were found to have spread systemic risks. Leaders of the Group of 20 (G20) have agreed to strengthen the oversight and regulation of global systemically important financial institutions. The Financial Stability Board has approved a framework for globally systemically important financial institutions that includes a requirement for additional loss-absorbing capacity for banks (a capital conservation buffer above the minimum requirements of Basel III), and enhanced supervisory intensity. With regard to the resilience of global systemically important insurers, the International Association of Insurance Supervisors will finalize for the G20 Brisbane Summit a basic capital requirement on which higher loss absorbency for such insurers will be built.

31. With respect to resolution of financial institutions, the Financial Stability Board framework requires authorities to put in place resolution regimes that provide for comprehensive resolution powers and effective mechanisms for cross-border cooperation in resolution, including through the development of institution-specific recovery and resolution plans. The Board also announced its intention to submit a

[12] Letter from the Chair of the Financial Stability Board to G20 ministers and governors on financial reforms (4 April 2014).

proposal to the G20 Brisbane Summit on the "gone-concern loss-absorbing" capacity of global systemically important financial institutions, although there is still work to be done to hone in on a range of important issues, such as the criteria that bank liabilities should meet to be considered as having "gone-concern loss-absorbing" capacity, the appropriate amount of such capacity that systemically important banks should hold and where in the structure of banking groups "gone-concern loss-absorbing" capacity should be held. Further legislative measures should be taken to put in place the arrangements for cross-border cooperation in resolution, consistent with the Board's recommendations. In this regard, on 15 April 2014 the European Parliament adopted the Bank Recovery and Resolution Directive.

32. Moreover, Financial Stability Board members are currently reviewing a study prepared by the Board in collaboration with IMF and the Organization for Economic Cooperation and Development, on the cross-border consistency and global financial stability implications of planned or implemented domestic banking reforms in individual jurisdictions. The assessment highlights that, while many measures help to address the too-big-to-fail problem, they may also have impacts on financial institutions and markets in third countries.[13] Several concerns relate to cross-border effects and perceived home bias in the design or implementation of reforms, the need to reduce reliance on credit ratings in regulations, as well as the need for ongoing dialogue and cooperation between national authorities in both developed and developing countries.

33. Progress on the reform of the derivatives market has been generally slow. To reduce risks in the derivatives market, the G20 agreed that all standardized over-the-counter derivatives should be traded on formal exchanges or electronic platforms and cleared by central counterparties by the end of 2012. The G20 leaders also agreed on imposing margin and capital requirements for non-centrally cleared over-the-counter derivatives and for the reporting of all such derivatives contracts to trade repositories. However, while the majority of jurisdictions have completed their legislative reforms or expect to have necessary legislative frameworks in place in 2014, progress on moving trading of standardized contracts to exchanges and electronic trading platforms is slow. This lack of consistency in jurisdictions' approaches remains a challenge, since it may lead to issues of overlapping, duplication, inconsistencies, conflicts or gaps in regulatory requirements being applied in cross-border contexts.[14]

34. Implementation, supervision and enforcement of other regulatory initiatives under discussion remain crucial, such as work on accounting standards, reduction in the reliance on credit rating agencies, reform of certain compensation practices and the establishment of macroprudential regulatory frameworks and countercyclical buffers.

35. The development and implementation of international financial regulation would also benefit from greater representation of and participation by developing countries in the regulatory reform process. Despite some progress, formal representation in international financial regulatory bodies, such as the Basel

[13] IMF, World Bank, Financial Stability Board, "Identifying the effects of regulatory reforms on emerging market and developing economies: a review of potential unintended consequences" (report to the G20 finance ministers and central bank governors, 2012).

[14] Financial Stability Board, *Over-the-counter Derivatives Market Reforms: Seventh Progress Report on Implementation* (April 2014).

Committee on Banking Supervision and the Financial Stability Board, is limited to advanced economies and a number of major emerging market economies. Moreover, there appears to be no momentum for change in governance structures. For example, in a recent review, Board members have expressed their view that the current membership has reached the upper limit consistent with maintaining effectiveness.[15]

V. International public finance and official development assistance

36. International public finance, and official development assistance (ODA) in particular, remains a critical source of public financing for development, particularly for those countries that have limited capacity to raise public resources domestically, including the least developed countries and other vulnerable countries. For those countries, ODA remains the largest source of external financing. At the same time, international public finance is increasingly looked upon to finance other global needs, such as global public goods and climate finance.

37. ODA provided by members of the OECD Development Assistance Committee (OECD DAC) rose by 6.1 per cent in real terms in 2013 to reach a record $134.8 billion.[16] After two consecutive years of decline in the aftermath of the global financial and economic crisis and fiscal contraction in donor countries, ODA rebounded and, according to donor surveys, is likely to increase further in 2014 and stabilize thereafter.

38. Despite the increase in aid flows, many donors still fall significantly short of commitments. Five donors (Denmark, Luxembourg, the Netherlands, Norway and Sweden) exceed the target of disbursing 0.7 per cent of their gross national income as aid, but the combined DAC donors' ODA was equivalent to only 0.3 per cent of their gross national income.[17]

39. Bilateral net ODA to the least developed countries also increased, by 12.3 per cent, to reach $30 billion, but this was mostly owing to exceptional debt relief for Myanmar. ODA to sub-Saharan Africa decreased in real terms to $26.2 billion.[17] DAC surveys on donors' forward spending plans indicate that aid flows will increasingly focus on middle-income countries in the medium term, with further declines projected for least developing countries and low-income countries, particularly in sub-Saharan Africa.[18]

40. In addition to increasing the volume of aid flows, many countries have committed themselves to enhancing the effectiveness of aid. Building on the Paris Declaration on Aid Effectiveness and the Accra Agenda for Action, the 2011 Busan Partnership agreement endorses four principles of effective development

[15] Financial Stability Board, "Meeting of the Financial Stability Board in London on 31 March", press release 19/2014; letter of the Chair of the Financial Stability Board to G20 ministers and governors on financial reforms dated 4 April 2014.

[16] OECD, "Aid to developing countries rebounds in 2013 to reach an all-time high". Available from: www.oecd.org/newsroom/aid-to-developing-countries-rebounds-in-2013-to-reach-an-all-time-high.htm.

[17] *MDG Gap Task Force Report 2013: The Global Partnership for Development — the Challenge We Face* (United Nations publication, Sales No. E.13.I.5).

[18] OECD, "Outlook on aid: survey of donors' forward spending plans 2013-2016" (3 April 2013).

cooperation: ownership of development priorities by developing countries; a focus on results; inclusive development partnerships; and transparency and accountability. Progress has been made in some areas, such as untying aid, reporting ODA in the national budgets, and using country administrative systems in the management of aid-funded programmes and projects. Nonetheless, progress remains slow, and aid providers face heightened scrutiny from taxpayers, with implications for resource allocations, modalities for delivery and risk management.[19]

41. South-South cooperation continues to rise in scale and importance, together with growing South-South trade, investment and regional integration. Several non-DAC donors have dramatically scaled up aid in recent years. South-South concessional loans, grants and technical cooperation have reached between $16.1 billion and $19 billion in 2011, and are estimated to constitute 10 per cent of overall development cooperation (see E/2014/77). South-South cooperation tends to come with limited conditionality, though it is often tied to profit-oriented projects. It covers a wide range of sectors, but often focuses on infrastructure and production.

42. As environmental degradation and climate change have become increasingly urgent issues in international development, climate financing has taken centre stage. In the 2009 Copenhagen Accord of the United Nations Framework Convention on Climate Change, developed countries agreed to the joint mobilization of $100 billion annually by 2020 to address the needs of developing countries. As an initial step, they also committed to providing $30 billion in new and additional finance — so-called fast-start finance — between 2010 and 2012. A preliminary assessment of fast-start finance reveals that commitments were exceeded, and $35 billion mobilized between 2010 and 2012. However, for the most part, this has not been additional to traditional ODA — 80 per cent of those flows were also counted as ODA, and were disbursed with similar modalities, largely through bilateral channels.[20] Fast-start finance has benefited middle-income countries disproportionally; often focused on leveraging private financing flows, less than half of it was delivered as grants. Climate financing remains more broadly focused on mitigation, while financing for adaptation — which is critical for the most vulnerable countries — is lacking.

43. New and innovative sources of development financing can make a key contribution to raising international public resources, in particular for the financing of global public goods. It has been estimated that around $400 billion to $450 billion per year could be raised through international taxes on financial transactions, carbon emissions and other mechanisms.[21] Innovative instruments can also be used to create incentives for behaviour change, for example, to encourage investments in green energy. Thus far, however, innovative mechanisms have been implemented on a relatively small scale, albeit with positive results.

44. International public finance plays a unique role and existing commitments have to be met and additional mobilization of resources will be needed. Nonetheless, on its own it will not be sufficient to finance sustainable development

[19] OECD and UNDP, *Making Development Cooperation More Effective: 2014 Progress Report* (2014).

[20] Overseas Development Institute, World Resources Institute, Institute for Global Environmental Strategies, "Mobilizing international climate finance: lessons from the fast-start period" (2013).

[21] *World Economic and Social Survey 2012: In Search of New Development Finance* (United Nations publication, Sales No. E.12.II.C.1).

needs. In view of the huge investment requirements, it will have to be complemented by increased domestic resource mobilization and by additional private financing that has been given the incentive to support sustainable development.

VI. Sovereign debt distress

45. There has been considerable change in the landscape of sovereign debt of developing countries since the Monterrey Consensus. Debt ratios of low- and middle-income countries have fallen dramatically, many middle-income countries have developed domestic sovereign debt markets, and an increasing number of low- and middle-income countries are able to access international capital markets.

46. The external debt stock of developing countries is low by historical standards, although the aggregate picture masks problems in some countries. In 2013, developing countries registered external debt-to-gross domestic product (GDP) ratios of, on average, 22.6 per cent of GDP. This compares to debt levels of, on average, 35 per cent of GDP only a decade earlier. The debt problem is more pronounced in many small States which have some of the highest debt-to-GDP ratios in the world. The short-term external debt stock has been growing and is significant in lower- and upper-middle-income countries. In the developing world, many low- and middle-income countries are accessing international capital markets, some of them for the first time. There is considerable diversity in their initial conditions and their ability to manage risk and refinance debt. Low-income countries, covered under the Highly Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative, are experiencing renewed debt-carrying capacity and market access and some have engaged in a rapid debt build-up, facilitated by a favourable interest rate environment, which needs to be monitored.

47. There is renewed impetus to the debate on sovereign debt restructuring mechanisms in the United Nations system,[22] the private sector and policy think-tanks. The debate is, in no small measure, influenced by the ramifications of the Argentine litigation in United States courts[23] and the "exceptional access" waiver of IMF lending policy for the highest bailout in history for Greece. There is also an increasing realization that there are limits to the ability of countries to enact fiscal austerity; that delays in restructuring (sometimes due to efforts of the official sector to avert a banking crisis) are costly, and the real possibility that many countries may not be in a position to return to growth and stability without a debt restructuring. Together, these factors have significant implications for the role of IMF and the scale of its financing, and the timing and extent of debt restructuring.

48. A decade ago, after the failure to agree on a statutory approach for debt restructuring, contractual changes occurred and included tools to effectively

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[22] See IMF 2014. The Fund's Lending Framework and Sovereign Debt — Preliminary Considerations, June; and Schneider, Benu (2014). Sovereign Debt Restructuring: The Road Ahead, forthcoming in: *Life After Debt: Debt Crises Origins and Resolutions*, eds. Joseph E. Stiglitz and Daniel Heymann, Macmillan (July).

[23] On 15 June 2014, the Supreme Court upheld the decision of lower courts in the Argentine case. This is likely to increase the leverage of holdout creditors in similarly drafted pari passu clauses by granting them full payment, and in addition give them the rights to interfere with payments made to exchange bondholders and third parties intermediating these payments.

coordinate a diverse group of creditors through the introduction of collective action clauses in bond contracts and laying out voluntary principles for a code of conduct. Despite these developments, the challenge still remains on how to return a country that is in debt distress to a sustainable fiscal track, resuscitate its growth and balance the risks which debt restructuring poses to the banking system. Sometimes, all creditors do not participate in a restructuring and holdout, leading to either costly settlements or expensive litigation against the sovereign by holdout creditors. More generally, this can undermine the ability to reach negotiated settlements with creditors. Further improvements in contractual technology are needed to bind in holdout creditors, strengthen clauses in bond contracts to aggregate bonds of different series, and make provisions for standstills in bond contracts.

49. Restructuring bank debt through the London Club has also often been fraught with delays and inadequate relief. Bilateral debt was restructured at the Paris Club by its members. However, not all creditor Governments are members of the Paris Club. In recent years, financing flows emanating from South-South cooperation have increased. The issue still remains open on how to provide a comprehensive and adequate debt resolution for all components of debt and provide intercreditor equity and fair burden sharing between debtors and creditors, legal predictability and timeliness for a faster return to growth and debt sustainability.

50. The absence of an international bankruptcy court for sovereign debt restructuring to provide timely, predictable and impartial solutions to debt problems has increased the cost of sovereign debt restructuring for the debtor and the creditor, and in the case of systemically important countries, for global financial stability as well. It is not that sovereign debt restructurings do not take place, but often debt restructurings are "too little too late".[24] In practice, solvency problems are frequently dealt with like liquidity problems, often requiring multiple restructuring. It is difficult to give incentives to the debtor and the private sector to carry out pre-emptive debt reprofiling to avert a distressful situation. Going forward, a timely solution in cases of debt distress will ultimately reduce costs for all stakeholders. The ongoing work to enhance frameworks for sovereign debt restructuring at IMF, at the Department for Economic and Social Affairs of the Secretariat[25] and at the secretariat of the United Nations Conference on Trade and Development (UNCTAD)[26] is the first step in moving towards a much-needed reform in the international financial architecture for debt restructuring.

VII. Multilateral reform

A. Global financial safety nets

51. A reliable global financial safety net remains an important element in ensuring global financial stability. A safety net can provide liquidity in times of systemic crisis, and reduce the incentive for countries to accumulate excess reserves as a form of self-insurance against adverse shocks. In this regard, IMF has quadrupled its

[24] IMF, *Sovereign Debt Restructuring — Recent Developments and Implications for the Fund's Legal and Policy Framework* (April 2013).

[25] www.un.org/esa/ffd/msc/externaldebt/index.htm.

[26] UNCTAD, "Draft principles on promoting responsible sovereign lending and borrowing" (Geneva, 26 April 2011). Available from http://unctad.org/en/Docs/gdsddf2011misc1_en.pdf.

lending resources since the global crisis and has revamped its lending toolkit, which has enabled it to enhance its ability to pre-empt and mitigate financial crises, contributing to the strengthening of the global financial safety net.

52. Through its lending reform following the world financial and economic crisis, IMF has introduced several new facilities with the key objective of reducing the perceived stigma of borrowing from the Fund and to encourage countries to ask for assistance before they face a full-blown crisis. These instruments include the Flexible Credit Line, which provides large and up-front access to IMF resources for members with very strong fundamentals and institutional policy frameworks and strong policies, and the Precautionary and Liquidity Line, which provides financial support to countries with sound policies but moderate vulnerabilities. According to IMF, as at April 2014, three countries, Colombia, Mexico and Poland, had used the Flexible Credit Line. While none of the three countries have thus far drawn down on these lines, they provided insurance during periods of heightened risk. Also according to the Fund, the Precautionary and Liquidity Line has to date been used by the former Yugoslav Republic of Macedonia and Morocco.

53. IMF has also refined the overall lending framework for low-income countries, with a view to increasing the flexibility of existing instruments, including by relaxing timing restrictions on access under the Standby Credit Facility, providing options for Extended Credit Facility arrangements with longer initial durations, increasing flexibility in the phasing of disbursements, and easing the poverty reduction strategy documentation requirements of the Extended Credit Facility and the Policy Support Instrument. In addition, the Rapid Credit Facility, which was created under the Poverty Reduction and Growth Trust, provides a disbursement with limited conditionality for low-income countries. The Rapid Credit Facility has a grace period of five and one-half years, and a final maturity of ten years. Financing under all concessional facilities under the Poverty Reduction and Growth Trust carry a zero interest rate, owing to a temporary exceptional waiver on interest rate which is in effect up to the end of 2014. The Fund is expected to review the interest rate level at the end of 2014.

54. In order to preserve the Fund's ability to provide financial support to low-income countries, the IMF Executive Board decided, in September 2012, to distribute to the membership in proportion to their quota shares special drawing rights of $1,750 million (about $2.7 billion) of the general reserve attributed to gold sale windfall profits. This distribution was subject to the provision of satisfactory assurances by members that they make new concessional lending subsidy contributions equivalent to at least 90 per cent of the amount distributed. On 10 October 2013, the Fund obtained the required pledge.[27]

55. The global financial safety net consists of a multilayered structure with global, regional, bilateral and national components. Country reserves represent one element of this. Additional liquidity needed to ease funding pressures during the financial crisis was provided through a series of ad hoc arrangements among key central banks. The involvement of major central banks will remain pivotal for a functioning and sufficient global financial safety net. In some cases, more permanent frameworks of liquidity lines among key central banks have been introduced. For example, in October 2013, the United States Federal Reserve institutionalized the

[27] www.imf.org/external/np/fin/prgt/second.htm.

dollar swap lines put in place during the global financial crisis with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan and the Swiss National Bank, totalling $333 billion.

56. Regional financing arrangements can play an increasingly important role in the global financial safety net. Existing regional financial arrangements include the Arab Monetary Fund (established in 1976), the Latin American Reserve Fund (established in 1989), the European Union Balance of Payments Assistance Facility (established in 2002), the Chiang Mai Initiative Multilateralization (established in 2010), the Anti-Crisis Fund of the Eurasian Economic Community (established in 2009), as well as the European Stability Mechanism (established in 2012). Enhancing cooperation and increasing complementarities between IMF and these regional financing arrangements would contribute to global financial stability and sustainable growth. The G20 Principles for Cooperation between IMF and the regional financing arrangements, and the IMF stocktaking paper on its engagement with regional financing arrangements may provide a basis for enhanced cooperation in this regard. However, as noted in the paper, the G20 Principles stop short of providing specific guidance and do not go beyond broadly stating that enhanced cooperation would contribute to global financial stability. In that context, observers argue for more detailed guidelines on issues such as division of labour and institutional relations between the regional financing arrangements and the Fund. At the same time, the paper also recognizes the limited experience to date and the risk that co-financing by multiple institutions with differing mandates could add increased complexity in financing operations.[28]

57. However, a global mechanism for ensuring the swift and sufficient availability of substantial resources in order to stabilize market conditions in times of systemic liquidity crisis continues to be lacking. Efforts to further strengthen crisis-lending facilities should therefore focus on enhancing the various layers of the global financial safety net and strengthening cooperation among the mechanisms at different levels. A key element in strengthening the global financial safety net is closer dialogue among IMF, national central banks and regional and subregional mechanisms. In this regard, a stronger role for IMF in coordinating and managing the various layers of the global financial safety net system might be envisaged.

B. Multilateral surveillance and policy coordination

58. In recent years, IMF has taken a number of important steps to strengthen the quality and coverage of its surveillance activities, including placing greater emphasis on cross-border and cross-sectoral linkages and paying closer attention to the spillover effects of economic policies in the world's largest economies and to linkages between the financial sector and the real economy. The latest triennial surveillance review, completed in October 2011, found that IMF surveillance remained fragmented, with a lack of depth in risk assessments and insufficient focus on interconnections and transmission of shocks. In response, the IMF Executive Board adopted, in July 2012, the decision on bilateral and multilateral surveillance (integrated surveillance decision), with a view to strengthening the legal framework for surveillance. This decision, which took effect in January 2013, makes consultations under article IV of the IMF Articles of Agreement a vehicle not only

[28] IMF, *Stocktaking the Fund's Engagement with Regional Financing Arrangements* (April 2013).

for bilateral surveillance, but also for multilateral surveillance, and allows for discussions on the full range of spillover effects of member countries' policies on global economic and financial stability.

59. IMF is currently preparing for the 2014 triennial surveillance review to be presented to the Board in September, which will consider how effectively the Fund is implementing its "integrated" surveillance framework; examine the consistency and focus of IMF policy advice; and look at the even-handedness of IMF surveillance across its membership. Concurrently, a review of the Financial Sector Assessment Programme is being carried out. In December 2013, the IMF Executive Board revised the methodology for determining jurisdictions with systemically important financial sectors. The new methodology places greater emphasis on interconnectedness; expands the range of covered exposures; takes into consideration the potential for price contagion across financial sectors; and uses the most recent available data, while adhering to principles of relevance, transparency, and even-handedness. Based on the new methodology, the list of jurisdictions with systemically important financial sectors has been expanded from 25 to 29.

60. IMF has also increased its focus on the impact of risks to global stability emanating from the financial sector. A new financial surveillance strategy lays the foundation for developing a unified macrofinancial framework that takes account of the interdependencies of financial sectors and of linkages and interactions between macroeconomic and macroprudential policies in the medium term.

C. Governance reform

61. The IMF and the World Bank Group governance reforms in 2010 were important steps towards an improved governance structure considering representation, responsiveness and accountability. At the World Bank Group, the two phases of voice reforms resulted in an increase in the voting power of developing and transitional countries in the International Bank for Reconstruction and Development and the International Financial Corporation, as well as in an increase of Part II members' voting power in the International Development Association. The third sub-Saharan African chair on the World Bank Group's Board was created in 2010. In addition, several areas of institutional reforms were achieved, including strengthening diversity within management and staff, accelerating decentralization of operations and field presence, as well as several major internal governance reforms such as the process for the selection of the President. Much of the ongoing World Bank Group reforms agenda is further enhancing the Group's responsiveness to clients. An example of this is the Group's enhanced focus on results and such new instruments as the Program for Results.

62. In order for the proposed amendment to the IMF Articles of Agreement on reform of the IMF Executive Board to enter into force, acceptance by three fifths of the Fund's 188 members (or 113 members) having 85 per cent of the Fund's total voting power is required. As at 8 July 2014, 145 members having 76.97 per cent of total voting power had accepted the amendment. For the quota increases under the Fourteenth General Review of Quotas to become effective, the entry into force of the proposed amendment to reform the Executive Board is required, as well as the consent to the quota increase by members having not less than 70 per cent of total

quotas (as at 5 November 2010). As at 8 July 2014, 162 members having 79.54 per cent of the total quota had consented.

63. The largest IMF shareholder has not yet adopted the measures necessary to ratify the 2010 Quota and Governance Reforms. The International Monetary and Financial Committee (IMFC) and G20 expressed their commitment to the progress of the IMF governance and quota reform in the communiqué issued at the meeting of G20 finance ministers and central bank governors held from 10 to 12 April 2014. In addition, in the communiqué of the twenty-ninth meeting of IMFC, participants in the meeting reaffirmed the importance of IMF as a quota-based institution and their commitment to maintaining a strong and adequately resourced IMF. If the 2010 reforms are not ratified by the end of 2014, IMFC and G20 will call upon IMF to build on its existing work and develop options for the next steps.

VIII. Conclusions

64. **The international financial system will be critical for the implementation of the post-2015 development agenda. Multilateral cooperation should be geared towards enabling the global financial system and domestic financial sectors to intermediate savings and investment more efficiently to help meet sustainable development needs while safeguarding financial stability.**

65. **Developing countries remain exposed to sudden changes in financial market sentiment and volatility of private flows. Sound macroeconomic policies, macroprudential measures and capital account regulations should be viewed as parts of a toolkit to help to prevent economic distortions and to address possible systemic vulnerabilities in the financial system caused by capital flow surges and outflows.**

66. **Institutional investors are viewed as a potential source of long-term investment for sustainable development. However, to date, most of their investment is in liquid instruments. Reforms are needed to create a more long-term oriented investor base, both at the global and national levels.**

67. **Despite notable progress, international financial regulatory reform remains behind schedule. For the system to be instrumental in financing the post-2015 development agenda, more attention will need to be given to how regulatory structures impact access to credit in areas that are critically important for sustainable development, such as infrastructure, innovation, and small and medium-sized enterprises.**

68. **For a fundamental reform of the global financial system, progress is needed in four major areas: (a) building resilience of financial institutions; (b) transforming shadow banking to transparent and resilient market-based financing; (c) ending too-big-to-fail; and (d) making derivatives markets safer.**

69. **The implementation, supervision and enforcement of other regulatory initiatives under discussion remain crucial as well and should be given more prominence in the international agenda. Such initiatives include work on the convergence of accounting standards, reduction in the reliance on credit rating agencies, reform of certain compensation practices and the establishment of macroprudential regulatory frameworks and countercyclical buffers.**

70. **The persistent lack of a timely, predictable and impartial solution to debt problems has increased the cost of sovereign debt restructuring for the debtor and the creditor, and in the case of systemically important countries, for global financial stability as well. Going forward, a timely solution in cases of debt distress will ultimately reduce costs for all stakeholders. The ongoing work to enhance frameworks for addressing sovereign debt distress is an important step towards strengthening this element of the international financial architecture.**

71. **Regional financing arrangements can play an increasingly important role in the global financial safety net. Enhancing cooperation and increasing complementarities between IMF and regional financing arrangements is important for global financial stability and sustainable growth. However, there is a need for a global mechanism to ensure the swift and sufficient availability of substantial resources, in order to stabilize market conditions in times of systemic liquidity crisis.**

72. **The global economic governance structures have to further evolve in order to broaden and strengthen the participation of developing countries and countries with economies in transition in international economic decision-making and norm-setting. The implementation of the 2010 IMF Quota and Governance Reforms would represent an important step forward if the largest shareholder of both IMF and the World Bank would adopt the necessary measures in 2014 for its ratification. The World Bank Group has committed to its next shareholding review in 2015. In addition, attention should be given to giving a greater voice to developing countries in other institutions, including the Financial Stability Board.**